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Central Intelligence Agency

Washington, D.C. 20505

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5 APR 1982

DDI

MEMORANDUM FOR: The Honorable William P. Clark
Assistant to the President for
National Security Affairs

SUBJECT: Mexican Financial Situation

In response to your request for more information on Mexico, we are forwarding to you a memorandum that we recently prepared on Mexico. It reviews the Mexican economic situation and its current financial crisis. If you have additional questions on Mexico, we will be happy to provide more information.

[redacted] 25X1

R. E. Hineman
Acting Deputy Director for Intelligence

Attachment:
As stated.

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ALA-M-82-10041

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[redacted]

18 March 1982

MEMORANDUM

SUBJECT: Mexican Financial Situation

Summary

1. Reacting to massive capital flight and depleted foreign exchange reserves, Mexico City devalued its currency by 40 percent in February. This initial step, however, was not followed up with the tough measures needed to stabilize domestic and international financial accounts, despite still serious economic and financial problems. Instead, Lopez Portillo sought to reduce the political backlash by cushioning the effect of the devaluation on jobs and consumption. At the same time, the devaluation boosted debt service obligations and made foreign payments pressures more intense. [redacted] 25X1

2. This year, Mexico City can probably avoid financial disruptions similar to those following the last devaluation in 1976. Prospects for continued large earnings from oil exports and President Jose Lopez Portillo's financial reputation will probably allow Mexico City to settle its foreign payments obligations without resorting to foreign government swaps or an IMF stabilization program. Nevertheless, a failure to adopt some austerity soon could put unbearable pressure on Mexico's foreign accounts and lead to a debt rescheduling that could disrupt international financial circles. Still more important for the long term, the recurrence of financial crisis within six years signals problems in Mexican political will and structure that point to further losses in the oil dividend to foreign debt service and domestic subsidies. [redacted] 25X1

Reaping the Oil Dividend

3. From the mid-1970s on, Mexico took the full opportunity to spend from its enhanced oil dividend and looked outside for still more funds. Average real economic growth of 8.5 percent yearly since 1977 was achieved by boosting imports 40 percent a year, running ever-larger current account deficits, and borrowing heavily to cover the difference. Foreign bankers, attracted by the rapid development of large oil reserves, were willing lenders. During the five years ending in 1981, external debt tripled to \$67.5 billion, pushing Mexico into the same league as Brazil, the largest LDC debtor. [redacted] 25X1

4. The soaring government spending made possible by the oil boom soon collided with severe bottlenecks in productive capacity and skilled manpower. This led to a serious overheating of the economy. Following some subsidence in 1978-79, inflation passed the 25-percent mark in 1980 and is on its way to 50 percent or more this year. [redacted] 25X1

5. Still the political payoff from rapid economic growth and massive public spending has been substantial. Enough jobs have been created to prevent unemployment from increasing as new entrants flooded the labor force. In addition, the government has been able to continue large-scale subsidy of consumption and living standards. [redacted] 25X1

The Turning Point

6. To finance 8-percent economic growth last year, Mexico relied on higher oil revenues and a doubling of foreign and domestic borrowing to cover its $25 billion budget deficit (12 percent of GDP). Even though export revenues jumped over 40 percent to almost $14 billion, imports needed to sustain economic growth and higher debt service pushed the current account deficit to a record $11.7 billion. A critical point occurred last summer when Lopez Portillo fired the head of the national oil monopoly in a vain effort to keep Mexican oil export prices and revenues at projected levels; this disrupted Mexican oil-export contracting and unsettled the foreign financial community. Even with the increase in merchandise imports, capital and raw material shortages tightened and inflation rose to 28 percent. [redacted] 25X1

7. In the face of these trends, Mexico City refused to adopt any stabilization measures. In fact, seeking to end his presidential term without slowing the economy, Lopez Portillo at the end of last year presented a 1982 budget with a continued rapid expansion in government spending and a $40 billion deficit. [redacted] 25X1

Financial Pressures and Devaluation

8. Beginning in late 1981, after the fumbling oil-price changes, Mexico City began to encounter mounting lender resistance. Besides the oil-pricing debacle, factors in the growing concerns were: (a) the impact of the soft world oil market on Mexico's oil receipts; (b) the sheer size of the debt; and (c) soaring budget deficits and inflation. As a result, beginning in the last half of 1981, Mexico City had to turn more and more to short-term, high interest loans to finance imports. [redacted] 25X1

9. By the beginning of 1982, Mexicans, too, lost confidence in government economic policies; as devaluation rumors mounted, they began converting pesos into dollars. A massive runup in capital flight in early February and the sudden depletion of

Mexico's international reserves forced the Bank of Mexico to float the peso on 17 February. The immediate impact was a 30-percent fall in the peso against the dollar on foreign exchange markets. [redacted] 25X1

Gaps in the New Strategy

10. Mexico City did not follow up the devaluation with tough steps needed to stabilize the economy and thereby seriously blunted the international and domestic benefits of the devaluation. In order to reduce the possibility of labor protests prior to July's presidential election, government spending was increased to cover wage hikes that were authorized in order to maintain workers' purchasing power. Additionally, credit was eased substantially to accommodate higher business wages and debt service bills. Mexico City belatedly added price controls on some consumer items after prices of many domestic goods were marked up faster than prices for imports. At the end of February, the peso dropped another 10 percent as a result of a deepening mistrust of government policies. [redacted] 25X1

Outlook for the Remainder of 1982

11. Despite sustained high government spending, Mexico's inflation and the soft world oil market will continue to discourage foreign bankers and will force Mexico City to cut imports and economic growth this year. If world oil prices stay at their current level, Mexico could boost foreign oil revenues $2 billion to about $16 billion by hiking oil sales to near its self-imposed export ceiling of 1.5 million barrels per day. Oil exports could not be boosted much higher -- even if a market could be found -- because current production capacity is about 3.0 million b/d and internal consumption is currently 1.5 million barrels per day. Questionable announcements of substantial boosts in proved oil reserves, a tested Mexican fund-raising gimmick, will probably not encourage international bankers to expand lending this time on the scale needed to boost imports to a level consistent with recent growth. [redacted] 25X1

12. Mexico's foreign debt structure will cause additional problems this year. Debt service obligations total $16 billion ($9 billion in interest and $7 billion in principle on medium- and long-term debt). In addition, Mexico City will have to roll over or reschedule another $16 billion in short-term debt if it is to avoid cutting imports even further. [redacted] 25X1

13. Until Mexico City is willing to cut spending, economic problems will intensify. As higher spending presses against lower imports, inflationary pressures will mount further and put greater downward pressure on the peso. During the next few months, Mexico City will avoid slashing spending; after the July presidential elections, however, the resistance of policymakers to austerity will weaken. [redacted] 25X1

The Comparison to 1976

14. Some similarities can be pointed out with the previous devaluation in 1976. Then, too, a rapid expansion in government spending had seriously worsened inflation and balance of payments deficits. In 1975 and 1976, Mexico City -- a net oil importer -- boosted wages, welfare spending, and government investments in an effort to sustain rapid economic growth and consumption in the face of higher oil prices and the world recession. Then, too, capital flight forced the devaluation. But erratic economic policies following the devaluation accelerated capital flight and forced Mexico City to draw down $665 million in US Treasury and Federal Reserve swaps to bridge over to a $1 billion IMF Extended Fund Facility loan. [redacted] 25X1

15. Financial dislocations this year will probably not be as severe as in 1976. This time, even though still resisting needed spending cuts, Mexico City intends to maintain the float rather than again pegging it to the dollar. In addition Mexico City is earnestly seeking the support of business, labor, and the general public. Also, unlike in 1976, Mexico City has emphasized that it would guarantee foreign currency bank accounts and peso convertibility. Another key difference is Mexico's vastly increased export potential. Mexican exports in 1981 were five times what they were in 1976, almost exclusively because of its new oil export capability. [redacted] 25X1

16. New imponderables face Mexico City in 1982, and there is some potential for more difficult adjustment than in 1977. The devaluation this time comes much earlier in the election process, and the sheer passage of time until the government can dig its heels in for austerity will have serious costs in the impact of the appropriate policies. This longer period for potential procrastination may also shape the speed with which short-term capital moves back into Mexico; the reflux could be much slower than in 1977. Finally, the international banking community appears much more wary of Mexico this time out, and loans will be tougher to negotiate and a good deal more costly. [redacted] 25X1

17. On balance, we feel that the Mexicans will weave their way through this tricky period with the only evident short-term losses hitting growth, domestic prices, and debt. Far more important, however, this recurrence of financial crisis within six years signals underlying problems in political structure that will haunt the Mexicans. If the government cannot muster the political will to respond rapidly to needed economic policy changes, Mexico risks wasting a substantial portion of its oil dividend on debt service and domestic subsidies. [redacted] 25X1

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